

**DESCRIPTION OF H.R. 6883**  
**RELATING TO**  
**REVISION OF INSTALLMENT SALE**  
**REPORTING RULES**  
**SCHEDULED FOR A HEARING**  
**BEFORE THE**  
**SUBCOMMITTEE ON**  
**SELECT REVENUE MEASURES**  
**OF THE**  
**COMMITTEE ON WAYS AND MEANS**  
**ON APRIL 17, 1980**

---

**PREPARED FOR THE USE OF THE**  
**COMMITTEE ON WAYS AND MEANS**  
**BY THE STAFF OF THE**  
**JOINT COMMITTEE ON TAXATION**



**APRIL 15, 1980**

**U.S. GOVERNMENT PRINTING OFFICE**  
**WASHINGTON : 1980**

60-653 O

JCS-20-80

3

19

20

# CONTENTS

---

	Page
Introduction-----	1
I. Summary-----	3
II. Present Law and Description of Bill-----	6
A. Installment sales generally-----	6
B. Initial payment limitation-----	7
C. Two-payment rule-----	7
D. Selling price limitation for casual sales of personal property-----	8
E. Election of installment reporting-----	8
F. Related party sales-----	9
G. Receipt of like kind property-----	12
H. Installment obligations distributed in a 12-month corporate liquidation-----	13
I. Sales subject to a contingency-----	14
J. Cancellation of installment obligation-----	15
K. Bequest of obligation to obligor-----	16
L. Foreclosure on installment obligations-----	17
M. Effective dates-----	17
N. Revenue effects-----	17



## INTRODUCTION

The bill described in this pamphlet (H.R. 6883, introduced by Messrs. Ullman, Conable, Rostenkowski, and Duncan of Tennessee) has been scheduled for a hearing on April 17, 1980, by the Subcommittee on Select Revenue Measures of the Committee on Ways and Means. The bill relates to the tax rules for reporting gain under the installment method for sales of real property and personal property other than inventory. This bill was developed as a result of the suggestions and comments received in connection with another bill, H.R. 3899, which was introduced last year.

A hearing was held by the Subcommittee on Select Revenue Measures of the Ways and Means Committee on the provisions of H.R. 3899 in July 1979. Senate hearings were also held on an identical bill, S. 1063, which had been introduced by Senators Long and Dole. At the hearings, most of the provisions of the bill were supported by the witnesses.

However, a number of modifications were suggested and a number of additional problems were raised for consideration. After the hearings, the staff was directed to develop a revised bill to simplify and improve this area of the tax law by taking into account the comments and testimony received. In developing the revised bill, the staff worked closely with the Treasury Department, the Tax Section of the American Bar Association, and the Federal Tax Division of the American Institute of Certified Public Accountants. In addition, comments and suggestions were received from a number of other professional organizations, including the New York City and State Bar Associations, and the Illinois and California Bar Associations. Also, several trade associations, including the American Bankers Association and representatives of farm groups, made comments and suggestions.

In connection with the hearing scheduled for H.R. 6883, the staff of the Joint Committee on Taxation has prepared for each provision a description of present law and the bill provision. The pamphlet also includes the estimated revenue effect of the bill.



## I. SUMMARY

### Revision of the Rules Relating to Certain Installment Sales

(H.R. 6883, Messrs. Ullman, Conable, Rostenkowski, and Duncan of Tenn.)

The bill (H.R. 6883) would amend the rules for reporting gains under the installment method for sales of real property and casual sales of personal property. (An identical bill, S. 2451, has been introduced in the Senate by Senators Long and Dole.)

The bill would make the following changes:

(1) **Structural improvements.**—Under present law, a single provision (Code sec. 453) prescribes rules for installment method reporting for dealers in personal property, for sales of real property and nondealer personal property, and special disposition rules. Under the bill, the basic rules for nondealer transactions would be contained in one Code section (sec. 453), the rules for dealer transactions would be contained in another section (sec. 453A), and generally applicable installment obligation disposition rules would be contained in a third section (sec. 453B).

(2) **Initial payment limitation.**—The bill would eliminate the requirement that no more than 30 percent of the selling price be received in the taxable year of sale to qualify for installment sale reporting for gains from sales of realty and nondealer personal property.

(3) **Two-payment rule.**—The bill would eliminate the requirement that a deferred payment sale be for two or more payments. Thus, a sale will be eligible for installment reporting even if the purchase price is to be paid in a single lump sum amount in a year subsequent to the taxable year in which the sale is made.

(4) **Selling price requirements.**—The bill would eliminate the requirement that the selling price for casual sales of personal property must exceed \$1,000 to qualify for installment sale reporting.

(5) **Election.**—The bill would eliminate the present law requirement that the installment method must be elected for reporting gains from sales of realty and nondealer personal property. Instead, the provision would automatically apply to a qualified sale unless the taxpayer elects not to have the provision apply with respect to a deferred payment sale.

(6) **Related party sales.**—The bill would prescribe special rules for situations where there is an installment sale to a related party who also disposes of the property.

Under the bill, the amount realized upon a resale by the related party installment purchaser would trigger recognition of gain by the initial seller, based on his gross profit ratio, only to the extent the amount realized from the second disposition exceeds actual payments



made under the installment sale. Thus, acceleration of recognition of the installment gain from the first sale would generally result only to the extent additional cash and other property flows into the related group as a result of a second disposition of the property.

The excess of any amount realized from resales over payments received on the first sale as of the end of a taxable year would be taken into account. Thus, the tax treatment would not turn on the strict chronological order of when resales or payments are made. If, under these rules, a resale results in the recognition of gain to the initial seller, subsequent payments actually received by that seller would be recovered tax-free until they equaled the amount realized from the resale which resulted in the acceleration of recognition of gain.

In the case of property other than marketable stock and securities, the resale rule would apply only with respect to second dispositions occurring within 2 years of the initial installment sale. In the case of marketable stock and securities, the resale rule would apply without a time limit for resales occurring before the installment obligation is satisfied.

The bill also contains several exceptions to the application of these rules. Since gain from the sale of a corporation's treasury stock is non-taxable and therefore its basis in the stock is irrelevant, the related party rule will not apply to any sale or exchange of stock to the issuing corporation. In addition, there generally would be no acceleration of recognition of gain as a result of a second disposition which is an involuntary conversion of the property or which occurs after the death of the installment seller or purchaser. Finally, the resale rules would not apply in any case where it is established to the satisfaction of the Internal Revenue Service that none of the dispositions had as one of its principal purposes the avoidance of Federal income taxes.

For purposes of the related party rules, the bill adopts a definition of related parties which will include spouses, children, grandchildren, and parents but will exclude brothers and sisters. However, it is to be understood that the omission of a specific family relationship is not intended to preclude the Internal Revenue Service from asserting the proper tax treatment to transactions that are shams.

**(7) Like-kind exchanges.**—The bill would provide that the receipt of like-kind property in connection with a disposition will not be taken into account in determining gain recognized for installment sale reporting purposes. Under the present Internal Revenue Service position, the receipt of like-kind property results in the recognition of installment gain before cash is received by the taxpayer because the value of such property is treated as a payment received. The bill would reverse this rule.

**(8) Installment obligations distributed in a corporate liquidation.**—The bill would provide nonrecognition of gain treatment for a shareholder who receives installment obligations as liquidating distributions from a corporation liquidating within 12 months of adoption of a plan of liquidation. In general, this rule would apply to obligations arising from sales by the corporation during the 12-month period. Obligations from the sale of inventory would qualify only if the inventory of that trade or business is sold in bulk. The gain realized by the shareholder on his stock would be recognized as payments



are received on the installment obligation. Thus, in most significant aspects, the tax consequences to a shareholder would be essentially the same whether the corporation sells its assets and then distributes installment obligations in liquidation or the shareholder makes an installment sale of the stock.

**(9) Sales subject to a contingency.**—The bill would permit installment sale reporting for sales for a contingent selling price. Under present law, these sales are not eligible for installment reporting. In extending eligibility, the bill does not prescribe specific rules which would apply to every conceivable transaction. Rather, the bill provides that the specific rules will be prescribed under regulations.

However, it is intended that, for sales under which there is a stated maximum selling price, the regulations will permit basis recovery on the basis of a gross profit ratio determined by reference to the stated maximum selling price. In cases where the sales price is indefinite but payable over a fixed period of time, it is generally intended that the basis of the property sold would be recovered ratably over that fixed period. In cases where the selling price and payment period are both indefinite, it is intended that the regulations would permit ratable basis recovery over some reasonable period of time. Also, in appropriate cases, it is intended that basis recovery would be permitted under an income forecast type period.

**(10) Cancellation of installment obligation.**—The bill would make it clear that the cancellation of an installment obligation other than by death is treated as a disposition of the obligation by the holder of the obligation.

**(11) Bequest of obligation to obligor.**—The bill would provide that the installment obligation disposition rules cannot be avoided by bequeathing an obligation to the obligor.

**(12) Foreclosure of real property sold on installment method by deceased taxpayer.**—The bill would provide that an executor or beneficiary who receives a secured installment obligation from a decedent will succeed the decedent for purposes of qualifying for nonrecognition treatment if the real property sold is reacquired in cancellation of the obligation.

**(13) Effective dates.**—In general, the bill would be effective for sales, cancellations, bequests, and reacquisition of real property, as the case may be, occurring after the date of enactment. However, the related party installment sale rules would apply to installment sales after March 31, 1980. The provision relating to the distribution of installment obligations in connection with a 12-month corporate liquidation would apply with respect to plans of liquidation adopted after the date of enactment.

## II. PRESENT LAW AND DESCRIPTION OF BILL

### A. Installment Sales Generally

#### *Present law*

Generally, under present law (Code sec. 453), income from a sale of property on the installment basis may be reported as the payments are received. If the installment method is elected for qualifying sales, the gain reported for any taxable year is the proportion of the installment payment received in that year which the gross profit, realized or to be realized when payment is completed, bears to the total contract price. In general, the contract price is the portion of the total selling price which will be paid to the seller.

The function of the installment method of reporting income is to permit the spreading of the income tax over the period during which payments of the sales price are received. Thus, the installment method alleviates possible liquidity problems which might arise from the bunching of gain in the year of sale when a portion of the selling price has not been actually received.

#### *Description of provision*

##### *In general*

Although the bill would make structural revisions of existing law and make the specific changes described below, the bill would continue the most basic concepts of existing law. As under present law, the provisions relate to installment reporting of gains and do not affect the time for recognizing losses from the sale or exchange of property for deferred payments.

Except as otherwise provided for sales subject to a contingency or for sales to certain related persons, gain would continue to be recognized for any taxable year from an installment sale for the payments received in that year in the same proportion as the gross profit from the sale bears to the total contract price. The payments taken into account as being received in a taxable year would not include the purchaser's obligation of future payment, whether dischargeable in money or other property (including foreign currency), unless that obligation is a bond or other evidence of indebtedness which is either payable on demand, or issued by a corporation or government and readily tradable.

##### *Structural improvements*

Under present law, a single provision (Code sec. 453) prescribes rules for installment method reporting for dealers in personal property, for sales of real property and nondealer personal property, and special disposition rules. Under the bill, the basic rules for nondealer transactions would be contained in one Code section (sec. 453), the

rules for personal property dealer transactions would be contained in another section (sec. 453A), and generally applicable installment obligation disposition rules would be contained in a third section (sec. 453B).

In making these structural changes and certain language changes, no substantive changes are intended to be made by the bill with respect to the provisions relating to dealers in personal property. The substantive changes under the bill relate only to sales of realty and casual sales of personal property.

For purposes of the bill, it is intended that gain from the sale of property, which is not required to be inventoried by a farmer under his method of accounting will be eligible for installment method reporting as gain from a casual sale of personal property.

## **B. Initial Payment Limitation**

### ***Present law***

Under present law, gain from the sale of realty or nondealer personal property may not be reported under the installment method if the payments received in the taxable year of sale exceed 30 percent of the selling price.<sup>1</sup>

### ***Description of provision***

The bill would eliminate the 30-percent initial payment limitation for reporting gain on the installment method from the disposition of real property or nondealer personal property.

## **C. Two-Payment Rule**

### ***Present law***

Under present law, it is the position of the Internal Revenue Service that a taxpayer may not elect to report income from the sale of real property on the installment method where the total purchase price is payable in a lump sum in a taxable year subsequent to the year of sale.<sup>2</sup> The same issue may arise with respect to casual sales of personal property. The rationale for the ruling is that the installment concept generally calls for two or more payments of the purchase price in two or more taxable years and that a single payment sale cannot be considered to require payments in installments. The courts have agreed with the Service's interpretation.<sup>3</sup>

### ***Description of provision***

The bill would eliminate the requirement that a sale must be for two or more payments to qualify for installment sale reporting. Thus, under the bill, income from the sale of qualifying property for a purchase price payable in a lump sum in a taxable year subsequent to the year of sale may be reported in the year in which payment is received.

<sup>1</sup> The problems associated with this limitation are set forth in a pamphlet prepared by the staff of the Joint Committee on Taxation for a hearing by the Subcommittee on July 27, 1979, on H.R. 3899 (JCS-34-79).

<sup>2</sup> Rev. Rul. 69-462, 1969-2 C.B. 107, amplified by Rev. Rul. 71-595, 1971-2 C.B. 223.

<sup>3</sup> *Baltimore Baseball Club, Inc., v. U.S.*, 481 F.2d 1283 (Ct. Cl. 1973); *10-42 Corp.*, 55 T.C. 593 (1971).



## D. Selling Price Limitation for Casual Sales of Personal Property

### *Present law*

Under present law, a casual sale of personal property must be for a selling price in excess of \$1,000 to qualify for installment reporting.<sup>4</sup>

### *Description of provision*

The bill would eliminate the selling price requirement to qualify for installment reporting.

## E. Election of Installment Reporting

### *Present law*

Under present law, an election can be made to report gain from an installment sale on a timely filed return, a delinquent return, or on an amended return for the year of sale not barred by the statute of limitations if the facts indicate no election inconsistent with the installment election had been made with respect to the sale (Rev. Rul. 65-297, 1965-2 C.B. 152). In the case where a return is filed which includes in gross income the entire gain from an installment sale, an amended return or claim for refund cannot be used to elect installment sale reporting for the sale because the election to report the gain in full is treated as a binding election.<sup>5</sup>

### *Description of provision*

The bill would eliminate the present law requirement that the installment method must be elected for reporting gains from sales of realty and nondealer personal property. Instead, the provision would automatically apply to a qualified sale unless the taxpayer elects not to have the provision apply with respect to a deferred payment sale. Generally, the election not to have installment sale reporting apply to a deferred payment sale must be made in the manner prescribed by regulations on or before the due date (including extensions of time for filing) for filing the income tax return for the year in which the sale occurs. Under regulations, elections made after the due date may be allowed. It is anticipated that late elections will be permitted in rare circumstances when the Internal Revenue Service finds that reasonable cause for failing to make a timely election exists under the particular circumstances of each case.

Generally, an election made under this provision is to be irrevocable. However, an election may be revoked with the consent of the Internal Revenue Service. Generally, it is anticipated that consent would be given by the Internal Revenue Service in circumstances when a revocation does not have as one of its purposes the avoidance of income taxes.

It is anticipated that the regulations will prescribe election rules relating to the treatment of gains from deferred payment sales of prop-

<sup>4</sup> If, for practical reasons, it is not feasible to report gain from sales for relatively small amounts, a taxpayer could elect not to report gain under the installment method and thereby eliminate compliance burdens. See the following discussion relating to installment sale elections under the bill.

<sup>5</sup> *Robert F. Koch*, T.C. Memo 1978-271; *Pacific National Co. v. Welch*, 304 U.S. 191 (1938).

erty by a nonresident alien. Under the installment sale rules of present law, these gains do not become taxable as payments are received after the seller becomes a resident or citizen subject to U.S. income tax for a taxable year subsequent to the year in which the sale was made. It is intended that the election regulations will continue this treatment in appropriate cases.

## F. Related Party Sales

### *Present law*

Under present law, the installment sale statutory provision does not preclude installment sale reporting for sales between related parties. Further, the statutory provision does not preclude installment sale reporting for sales of marketable securities although the seller might readily obtain full cash proceeds by market sales.<sup>6</sup>

Under the existing statutory framework, taxpayers have used the installment sale provision as a tax planning device for intra-family transfers of appreciated property, including marketable securities.<sup>7</sup> There are several tax advantages in making intra-family installment sales of appreciated property. The seller would achieve deferral of recognition of gain until the related buyer actually pays the installments to the seller, even if cash proceeds from the property are received within the related party group from a subsequent resale by the installment buyer shortly after making the initial purchase. In addition to spreading out the gain recognized by the seller over the term of the installment sale, the seller may achieve some estate planning benefits since the value of the installment obligation generally will be frozen for estate tax purposes. Any subsequent appreciation in the property sold, or in property acquired by reinvestment of the proceeds from the property sold on the installment basis, would not affect the seller's gross estate since the value of the property is not included in his gross estate.

With respect to the related buyer, there is usually no tax to be paid if the appreciated property is resold shortly after the installment purchase. Since the buyer's adjusted basis is a cost basis which includes the portion of the purchase price payable in the future, the gain or loss from the buyer's resale would represent only the fluctuation in value occurring after the installment purchase. Thus, after the related party's resale, all appreciation has been realized within the related group but the recognition of the gain for tax purposes may be deferred for a long period of time.

In the leading case, *Rushing v. Commissioner*,<sup>8</sup> the test was held to be that, in order to receive the installment benefits, the "seller may not directly or indirectly have control over the proceeds or possess the economic benefit therefrom." In this case, a sale of corporate stock was made to the trustee of trusts for the benefit of the seller's children.

<sup>6</sup> The receipt of the buyer's obligation payable on demand or readily tradable evidence of indebtedness is treated as the receipt of payment by the seller. For this purpose, readily tradable items include bonds and notes issued by a corporation or governmental unit with interest coupons attached or in registered form or in any other form designed to make the bond or note readily tradable in an established securities market.

<sup>7</sup> Another technique used for intra-family transfers involves the so-called "private annuity" arrangement. The bill does not deal directly with this type of arrangement.

<sup>8</sup> 441 F. 2d 593 (5th Cir. 1971) *aff'd* 52 T.C. 888 (1969).

Since the sales were made to trusts created after the corporations had adopted plans of liquidation, the Government made an assignment of income argument. The Court upheld installment sale treatment for the stock sold to the trustee under the "control or enjoyment" test because the trustee was independent of the taxpayer and owed a fiduciary duty to the children. The Court rejected the assignment of income argument because it found that no income was being assigned.

The *Rushing* case has been followed in another case where the stock sold to a family trust was that of a corporation which was to be liquidated after the sale.<sup>9</sup> The liquidation was formally authorized after the sale to the trust. In other cases, the Tax Court has rejected the Service's substance over form and constructive receipt arguments and held that sales to a family trust qualified for installment sale reporting.<sup>10</sup> In the *Pityo* case, the taxpayer's wife was the beneficiary of one of the trusts to which the installment sale was made. In the *Roberts* case, the trustees were the seller's brother and personal accountant. In both cases, installment sale reporting was allowed because the Tax Court held that the trustees were independent of the seller and satisfied the *Rushing* control or enjoyment test.

In another case, installment sale reporting was allowed for a sale of marketable stock by a wife to her husband although a resale by the husband was contemplated.<sup>11</sup> In this case, the Court held that the husband could not be considered a mere conduit for the wife's sale of the stock since both were "very healthy economic entities" and the husband had an independent purpose for obtaining needed funds for an investment at a low rate of interest.

### **Description of provision**

The bill would prescribe special rules for situations where there is an installment sale to a related party and the purchaser also disposes of the property.

Under the bill, the amount realized upon a resale by the related party installment purchaser would trigger recognition of gain by the initial seller, based on his gross profit ratio, only to the extent the amount realized from the second disposition exceeds actual payments made under the installment sale. Thus, acceleration of recognition of the installment gain from the first sale would generally result only to the extent additional cash and other property flows into the related group as a result of a second disposition of the property. In the case of a second disposition which is not a sale or exchange, the fair market value of the property disposed of is treated as the amount realized for this purpose.

The excess of any amount realized from resales over payments received on the first sale as of the end of a taxable year would be taken into account. Thus, the tax treatment would not turn on the strict chronological order in which resales or payments are made. If, under these rules, a resale results in the recognition of gain to the initial seller, subsequent payments actually received by that seller would be

<sup>9</sup> *Carl E. Weaver*, 71 T.C. 443 (1978).

<sup>10</sup> *William D. Pityo*, 70 T.C. 225 (May 15, 1978); *Clair E. Roberts*, 71 T.C. 311 (1978).

<sup>11</sup> *Nye v. U.S.*, 407 F.Supp. 1345, 75-1 USTC ¶ 9150 (M.D.N.C. 1975).



recovered tax-free until they equaled the amount realized from the resale which resulted in the acceleration of recognition of gain.

In the case of property other than marketable stock and securities, the resale rule would apply only with respect to second dispositions occurring within 2 years of the initial installment sale. For this purpose, the running of the 2-year period would be postponed for any period during which the related purchaser's risk of loss with respect to the property is substantially diminished. This rule would apply with respect to the holding of a put, the holding of an option by another person, a short sale, or any other transaction which has the effect of substantially diminishing the risk of loss. However, for this purpose, a typical close corporation shareholders' agreement is not intended to be taken into account.

In the case of marketable stock and securities, the resale rule would apply without a time limit for resales occurring before the installment obligation is satisfied. For this purpose, the term "marketable security" means any security for which, as of the date of disposition, there was a market on an established securities market, or otherwise. In appropriate cases, this determination would be made on the basis of the underlying assets of a corporation, e.g., a holding company whose assets consisted primarily of marketable securities. Thus, it is not intended that the marketable security rule be circumvented by the interposition of a holding company whose stock is not traded on an established securities market.

The bill also contains several exceptions to the application of these rules. Since gain from the sale of a corporation's treasury stock is nontaxable and therefore its basis in the stock is irrelevant, the related party rule will not apply to any sale or exchange of stock to the issuing corporation. In addition, there generally would be no acceleration of recognition of gain as a result of a second disposition which is an involuntary conversion of the property or which occurs after the death of the installment seller or purchaser. Finally, the resale rules would not apply in any case where it is established to the satisfaction of the Internal Revenue Service that none of the dispositions had as one of its principal purposes the avoidance of Federal income taxes.

Generally, the bill limits the specific exceptions to situations where the second disposition is of an involuntary nature. In cases of voluntary transfers, the nontax avoidance exception may apply. However, for these exceptional cases, it is anticipated that the regulations would provide definitive rules rather than having complicated legislation to prescribe substituted property or taxpayer rules which would not be of general application. In appropriate cases, it is anticipated that the regulations and rulings under the nontax avoidance exception will deal with certain tax-free transfers which normally would not be treated as a second disposition of the property, e.g., charitable transfers, gift transfers, and transfers to a controlled corporation or a partnership.

Under the bill, the period for assessing a deficiency in tax attributable to a second disposition by the related purchaser will not expire before the day which is 2 years after the date the initial installment seller furnishes a certificate that there was a second disposition of the property. The certificate is to be furnished in the manner prescribed by regulations. It is anticipated that the regulations will prescribe

rules for the filing of a protective certificate in cases where there are questions as to whether a second disposition has occurred, e.g., a lease which might be characterized as a sale or exchange for tax purposes, or whether there is a principal purpose of Federal income tax avoidance.

For purposes of the related party rules, the bill adopts a definition of related parties which will include spouses, children, grandchildren, and parents but will exclude brothers and sisters. However, it is to be understood that the omission of a specific family relationship is not intended to preclude the Internal Revenue Service from asserting the proper tax treatment of transactions that are shams.

## G. Receipt of Like Kind Property

### *Present law*

Under present law, the transfer of property for cash payments and like kind property may qualify both for installment sale reporting and, with respect to the gain attributable to the like kind exchange, nonrecognition treatment (Code sec. 1031 and Rev. Rul. 65-155, 1965-1 C.B. 356). In this case, the gain to be recognized under installment method reporting is the total gain realized on the transaction less the gain eligible for nonrecognition under the like kind exchange provision. However, the value of the like kind property received by the seller is taken into account in determining the amount of the selling price, the contract price, and payments received for purposes of the installment sale provision.<sup>12</sup>

### *Description of provision*

Under the bill, property permitted to be received without recognition of gain received in an exchange described in section 1031(b)<sup>13</sup> would not be treated as payment for purposes of reporting gain under the installment method.

Thus, in reporting the gain on the exchange under the installment method where an installment obligation is received in addition to the like kind property, the gross profit would be the amount of gain which would be recognized on the exchange if the installment obligation were satisfied in full as its face amount. Also, the total contract price would not include the value of the like property but instead would consist solely of the sum of the money and fair market value of other property received plus the face amount of the installment obligation.

The basis of the like kind property received, (determined under section 1031(d)) will be determined as if the obligation had been satisfied at its face amount.<sup>14</sup> Thus, the taxpayer's basis in the property

<sup>12</sup> Rev. Rul. 65-155, 1965-1 C.B. 356; *Clinton H. Mitchell*, 42 T.C. 953, 965 (1964); *Albert W. Turner*, TC Memo 1977-437. A similar case under present law involves the treatment of an installment obligation received as "boot" in exchange by a shareholder under a plan of corporate reorganization (sec. 356(a)(1)). Present law is unclear whether the exchange qualifies for installment sale reporting. See e.g. *Frances M. Avritt*, 37 B.T.A. 485 (1938), reversed on other grounds, 101 F.2d 644 (1st Cir. 1938).

<sup>13</sup> This provision includes like kind exchanges (sec. 1031), exchanges of certain insurance policies (sec. 1035), certain exchanges of stock of the same corporation (sec. 1036), and certain exchanges of United States obligations (sec. 1037).

<sup>14</sup> This is the same rule as presently set forth in Rev. Rul. 65-155, *supra*.

transferred will first be allocated to the like kind property received (but not in excess of its fair market value) and any remaining basis will be allocated ratably among the installment obligation and any cash or nonqualifying property.

The bill also provides that similar treatment applies in the case of an exchange under a plan of corporate reorganization described in section 356(a) which is not treated as a dividend.

These provisions may be illustrated by the following example. Assume that the taxpayer exchanges property with a basis of \$400,000 for like kind property worth \$200,000, and an installment obligation for \$800,000 with \$100,000 payable in the taxable year of the sale and the balance payable in the succeeding taxable year. The example compares present law which takes like kind property into account as payment with the bill which reverses this rule.

	<i>Rev. Rul. 65-155— amount taken into account</i>	<i>Like kind property not taken into account</i>
Contract price-----	\$1, 000, 000	\$800, 000
Gross profit-----	600, 000	600, 000
Gross profit ratio (percent)-----	(60)	(75)
Gain to be reported for:		
1. Taxable year of sale:		
(a) 60% of \$300,000 (payments "received" of \$100,000 cash and \$200,000 value of like property)-----	\$180, 000	
(b) 75% of \$100,000 (cash pay- ments)-----		\$75, 000
2. Succeeding taxable year:		
(a) 60% of \$700,000 (cash re- ceived)-----	420, 000	
(b) 75% of \$700, 000 (cash re- ceived)-----		525, 000
Total Gain Recognized-----	\$600, 000	\$600, 000

## H. Installment Obligations Distributed in a 12-Month Corporate Liquidation

### *Present law*

Under present law, gain or loss is not generally recognized at the corporate level for sales and exchanges occurring during the 12-month period after the corporation has elected a plan of liquidation (Code sec. 337). A special rule provides that in this situation gain or loss generally is not recognized to the liquidating corporation for distributions of installment obligations (Code sec. 453(d)(4)(B)). Gain or loss is recognized by the shareholders with respect to the liquidating distributions. No special exception applies for the distribution of



installment obligations to shareholders so that the shareholders can defer reporting gain from the obligations.

### ***Description of provision***

Under the bill, in the case of a corporate liquidation (under sec. 331) the receipt by a shareholder of an installment obligation which was received by the corporation during its 12-month liquidation period (under sec. 337) would not be treated as the receipt of payment by the shareholder. Instead, the shareholder may report its gain from the exchange of its stock on the installment method, taking gain into account as payments are received on the installment obligation. Where a parent liquidating corporation had a subsidiary which received an obligation during the subsidiary's liquidation (to which sec. 337(c)(3) applied) that obligation also would qualify for installment reporting by the shareholders of the parent corporation. However, in no event would obligations received by the liquidating corporation from the sale of inventory, other than from a bulk sale, qualify for installment treatment by the shareholder.

Where liquidating distributions are received by a shareholder in more than one taxable year, the shareholder would be required to recompute the gain reported from the liquidation by allocating basis in the stock pro rata over all payments received (or to be received). This may require amended returns if the liquidating distributions are not all received during the same taxable year of the shareholder.

## **I. Sales Subject to a Contingency**

### ***Present law***

As a general rule, installment reporting of gain from deferred payments is not available where all or a portion of the selling price is subject to a contingency. The case law holds that the selling price must be fixed and determinable for section 453(b) to apply.<sup>15</sup> An agreement, however, to indemnify the purchaser for breach of certain warranties and representations by offset against the purchase price will not disqualify an installment sale under section 453(b).<sup>16</sup> Exactly how broad such contingencies can be is unclear.

Where an installment sale is subject to a contingency with respect to the price and the installment method is not available, the taxpayer is required to recognize all of the gain in the year of the sale with respect to all of the payments to be made, even though such payments are payable in future taxable years. In the case of a cash-method taxpayer where the future payments have no readily ascertainable fair market value, the taxpayer may treat the transaction with respect to those payments as "open" and use the cost-recovery method under *Burnett v. Logan*, 2830 U.S. 404 (1931).

### ***Description of provision***

The bill would permit installment sale reporting for sales for a contingent selling price. In extending eligibility, the bill does not prescribe specific rules which would apply to every conceivable transac-

<sup>15</sup> *Gralapp v. United States*, 458 F.2d 1158 (10th Cir. 1972); *In re Steen*, 509 F.2d 1398 (9th Cir. 1975).

<sup>16</sup> See Rev. Rul. 77-56, 1977-1 C.B. 135.

tion. Rather, the bill provides that the specific rules will be prescribed under regulations.

However, it is intended that, for sales under which there is a stated maximum selling price, the regulations will permit basis recovery on the basis of a gross profit ratio determined by reference to the stated maximum selling price. For this purpose, the maximum selling price would be determined from the "four corners" of the contract agreement as the largest price which could be paid to the taxpayer assuming all contingencies, formulas, etc., operate in the taxpayer's favor. Income from the sale would be reported on a pro rata basis with respect to each installment payment using the maximum selling price to determine the total contract price and gross profit ratio. If, pursuant to standards prescribed by regulations, it is subsequently determined that the contingency will not be satisfied in whole or in part, thus reducing the maximum selling price, the taxpayer's income from the sale would be recomputed. The taxpayer would then report reduced income, as adjusted, with respect to each installment payment received in the taxable year of adjustment and subsequent taxable years. If the maximum price is reduced in more than one taxable year, *e.g.*, because of successive changes in the status of the contingency, each such year of reduction would constitute an adjustment year.

Where the taxpayer has reported more income from installment payments received in previous taxable years than the total recomputed income, the taxpayer would be permitted to deduct the excesses in the adjustment year as a loss.

In cases where the sales price is indefinite and no maximum selling price can be determined but the obligation is payable over a fixed period of time, it is generally intended that basis of the property sold would be recovered ratably over that fixed period. In a case where the selling price and payment period are both indefinite but a sale has in fact occurred, it is intended that the regulations would permit ratably basis recovery over some reasonable period of time. Also, in appropriate cases, it is intended that basis recovery would be permitted under an income forecast type method.

## J. Cancellation of Installment Obligation

### *Present law*

Under present law, some have argued that the installment obligation disposition rules can be avoided by making gift cancellations of the obligation or the installments as they come due. In other words, by making an installment sale and then cancelling the obligation or a number of installment payments, it is argued that the seller will incur no income tax liability, but possibly some gift taxes, and the buyer will have a cost basis in the property sold although no income tax cost will have been incurred on the transaction. If a direct gift is made, the donee's basis is generally the same as the donor's basis rather than a "cost" basis which reflects future payments which will never be made.

This cancellation technique is based on a District Court's decision in *Miller v. Usry*.<sup>17</sup> In that case, the court held that the disposition

<sup>17</sup> 160 F. Supp. 368, 58-1 USTC ¶ 9393 (W.D. La. 1958).

rules for obligations disposed of other than by sale or exchange were directed at corporate transfers and should not be applied to a cancellation of the obligation where there has been no actual, or real, or material gain to the taxpayer. The court did not consider the possible benefit to the donee from acquiring a cost basis through the installment sale. Next, the court held that the disposition rules for satisfaction at other than face value did apply to a cancellation but no tax was incurred because no amount was realized by the taxpayer.

### ***Description of provision***

The bill would make it clear that the cancellation of an installment obligation is treated as a disposition of the obligation. In the case where the obligor is a related party, the amount taken into account as a disposition triggering recognition of unreported gain attributable to the obligation is not to be less than the face amount of the installment obligation.

## **K. Bequest of Obligation to Obligor**

### ***Present law***

Under present law, the installment obligation disposition rules do not apply to the transmission of installment obligations at death (Code secs. 453(d)(3) and 691(a)(4)). However, installment obligations are treated as items of gross income in respect of a decedent so that the recipient is taxed upon receipt of the installment payments in the same manner as the deceased seller would be if he had lived to receive the payments. A special rule allows a deduction for the estate taxes attributable to the unreported gain on the installment obligation.

Another provision (Code sec. 691(a)(2)) provides that the transfer of an installment obligation to the estate of the deceased seller will not be treated as a transfer requiring the reporting of gain. In addition, this rule applies to a transfer to a person pursuant to the right of such person to receive the installment obligation by reason of the death of the seller or by bequest, devise, or inheritance from the seller. Because of these rules, it has been argued that any unreported gain upon the death of the seller will never be taxed if the installment obligation is left to the obligor. In this case, it is argued that there will never be a disposition or collection of the unpaid balance because there has been a merger of interests of obligor and obligee. In other words, the obligor will have acquired a cost basis for depreciation and resale purposes prior to the seller's death but no income tax cost will have been incurred with respect to the gain unreported by the seller at the time of his death.

### ***Description of provision***

The bill would provide that any previously unreported gain from an installment obligation would be recognized by a deceased seller's estate if the obligation is transferred or transmitted by bequest, devise, or inheritance to the obligor. In the absence of some act of cancelling the obligation by distribution or notation which results in cancellation under the Uniform Commercial Code or other local law, the disposition would be considered to occur no later than the time the period of administration of the estate is concluded.



## L. Foreclosure of Installment Obligations

### *Present law*

Under present law, the recognition of gain upon a reconveyance of real property to the seller in partial or full satisfaction of purchase money debt is limited (Code sec. 1038). Losses, including bad debt losses, are also not recognized upon a reconveyance of real property. With respect to gains, the amount of gain required to be recognized upon reconveyance of the real property sold generally is limited to the lesser of the amount of any remaining unreported portion of the original gain or the amount by which the sum of the money and fair market value of property received prior to the reacquisition exceeds the amount of gain previously reported. The Internal Revenue Service has ruled that this provision does not apply to a reconveyance to the estate of a deceased taxpayer who made the original sale (Rev. Rul. 69-83, 1969-1, C.B. 202). In other words, a decedent's estate is not permitted to succeed to the benefits which would have been available to the decedent had he lived to receive the reconveyance because the estate is considered to be a separate taxable entity.

### *Description of provision*

Under the bill, the estate or beneficiary of a deceased seller would be entitled to the same nonrecognition treatment upon the acquisition of real property in partial or full satisfaction of secured purchase money debt to which the deceased seller would have been entitled.

The basis of the property acquired would be the same as if the property had been reacquired by the original seller, increased by an amount equal to the section 691(c) deduction for estate taxes which would have been allowable had the repossession been taxable.

## M. Effective Dates

In general, the bill would be effective for sales, cancellations, and reacquisitions of real property, as the case may be, occurring after the date of enactment. However, the related party installment sale rules would apply to installment sales after March 31, 1980. The provision relating to the distribution of installment obligations in connection with a 12-month corporate liquidation would apply with respect to plans of liquidation adopted after the date of enactment of the bill.

## N. Revenue Effects

Due to the interaction between the provisions of this bill, revenue effects for each specific provision cannot be determined. It is estimated that on balance the provisions of this bill (except related party sales) will not have a significant revenue effect on budget receipts.

Due to the litigious nature of related party sales under present law, the revenue gain for this provision of the bill is indeterminant.

